BNA Insights

DOL Re-Opens Brokerage Window Inquiry: Will It Clear the Air or Leave Participants in 'Pane'?

BY STEVEN W. RABITZ

Sponsors of tax code Section 401(k) plans have long understood that plan fiduciaries bear a duty of prudence when it comes to the selection and monitoring of a plan's standard fare of investment options. However, in light of the increasingly varied demands of plan participants, some sponsors have opted to offer non-designated investment alternatives, including so-called "brokerage windows," in their plans as a way of increasing the control and choice of employees who wish to more actively participate in the management of their retirement savings.

Although for standard 401(k) offerings, prudent plan management dictates that plan fiduciaries closely monitor and, when appropriate, disclose plan investments, when choosing to offer brokerage windows, sponsors may have in part relied on past Department of Labor guidance that appeared to treat brokerage windows and "similar plan arrangements" as outside the requirements that apply to standard 401(k) offerings. However, in a widely scrutinized 2012 field bulletin, and more recently in an August 2014 request for information, the DOL may have presaged what could amount to a foundational change in the treatment of these investment alternatives that could alter the 401(k) landscape.

This article examines the DOL's 2012 field bulletin and August 2014 request for information, and the potential implications for plan sponsors, participants and other market participants. The information provided should also help readers assess the extent to which they may wish to provide information pursuant to the DOL's request (the deadline for which is November 19).

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Background and History

Many cash or deferred arrangements, such as 401(k) plans, allow participants to choose investments for their individual accounts across a limited set of specific investment options that are selected and monitored by a plan fiduciary. Some of these plans also offer "brokerage windows," a feature designed to enable participants to select investment options beyond those specifically designated by the plan fiduciary. Often, brokerage windows permit participants comparatively greater freedom by allowing them to purchase publicly traded securities and mutual funds that are offered on the sponsoring brokerage institution's platform. This, of course, results in a comparatively larger universe of investment choices when viewed against plans with a more traditional lineup of investment choices designated by a plan's fiduciaries.

The concept of a participant's investment control has been central to many of the features associated with the defined contribution landscape, including Section 404(c) of ERISA, discussed more below. In addition to allowing participants greater control and choice over where to invest their retirement funds, brokerage windows may be particularly desired where employees desire access to a specialized asset class or classes that are not traditionally available in a plan's investment alternative lineup. May brokerage windows offered are employee driven. For these reasons, many employers commonly choose to offer brokerage windows in order to permit participants to customize more individualized investment solutions. For example, participants may desire access to certain "socially responsible" investments or other religiously-compliant investment alternatives, which may not be permitted to be chosen by plan fiduciaries as an investment option under a plan in light of existing DOL guidance. The DOL in the past has expressed the view that in evaluating an investment opportunity, the fiduciary standards of ERISA do not preclude a plan fiduciary's consideration of collateral benefits, such as those offered by socially responsible funds or religiously-compliant investment alternatives. However, consideration of these features by the plan fiduciary may be decisive ***only*** if the fiduciary determines that the socially responsible investment is expected to provide an investment return commensurate to alternative investments having similar risks.

Depending on the philosophy of a given plan and sponsor, an employer may concurrently also make available individualized or other advice to plan participants to assist them in meeting their retirement goals. Many of these investment advice programs are offered by the particular brokerage institution where the accounts are maintained, or by other unrelated parties designated by or hired by the plan or sponsor to assist plan participants in making investment decisions.

When plan fiduciaries choose a menu of investment options under 401(k) plans, known as "designated investment alternatives" ("DIAs") plan administrators of those plans become subject to certain detailed disclosure rules, issued by the DOL in 2012 ("Section 404(a)(5) Disclosure Rules"). The Section 404(a)(5) Disclosure Rules are highly complex and were themselves the product of extensive comment and involve substantial preparation by plan administrators and other market participants.

These rules, in combination with the final ERISA Section 408(b)(2) disclosure regulations and Schedule C of Form 5500, formed a "trifecta" of new disclosure obligations designed by the DOL to enhance transparency. The Section 404(a)(5) Disclosure Rules defined a DIA as "any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual account." These rules also provided that the term "designated investment alternative" "*shall not include 'brokerage windows,' 'self-directed brokerage accounts,' or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.*" [Emphasis supplied].

On May 7, 2012, the DOL of its own accord issued Field Assistance Bulletin 2012-02 ("FAB 2012-02")[1] with respect to certain interpretative aspects of these newly finalized rules. Surprisingly, and notwithstanding the definition of DIA contained in the final Section 404(a)(5) Disclosure Rule, the DOL suggested in Question and Answer 30 ("Q&A 30") that individual securities and mutual funds selected by participants under a brokerage window could be viewed as a DIA subject to the Section 404(a)(5) Disclosure Rules where there is "significant participation" by participants in the plan in such a position. Furthermore, Q&A 30 implied that plan sponsors would have a fiduciary duty of prudence in monitoring the actual investment choices selected by participants through such brokerage window plans. Specifically, Q&A 30 provided:

> [i]f through a brokerage window or similar arrangement, non-designated investment alternatives available under a plan are selected by significant numbers of participants and beneficiaries, *an affirmative obligation arises on the part of the plan fiduciary to examine these alternatives and determine whether one or more such alternatives should be treated as designated for purposes of this section.* [Emphasis supplied].

Many market participants were surprised to read Q&A 30. Indeed, many perceived Q&A 30 as arguably (and unexpectedly) altering well-established expectations of plan fiduciaries' duties, and even as having introduced a new substantive requirement without benefit of the normal rule making process. The concern was prompted in no small part by the fact that neither the proposal nor final form of the Section 404(a)(5) Disclosure Rules appeared to address the matters addressed by Q&A 30.

Operational Concerns

Although plan fiduciaries clearly have a duty to prudently select and monitor a plan's investment menu of options that are offered in a "standard" 401(k) arrangement, it is difficult to see how, operationally, a plan fiduciary could monitor the prudence of each and every security that is offered in a brokerage account. If such a duty were imposed, would a fiduciary be entitled to rely only on publicly available information? What if the security in question was traded abroad in a developed market that did not offer disclosures identical to those in the United States in the public markets? What would happen if the shares were declining precipitously? Would a fiduciary somehow have a duty to encourage participants to sell their shares? What would the exposure be to fiduciaries if they did so, and then the shares subsequently rebounded?

Ignoring the considerable issues associated with the imposition of fiduciary duty on what are essentially "non-designated investments" chosen by the participant, the detailed Section 404(a)(5) Disclosure Rules mentioned above would apply to the security or mutual fund in a way that would at best be cumbersome and costly, and at its most likely, prone to inadvertent foot-faults resulting in unintentional noncompliance. Putting aside the fact that many of the disclosure rules were likely not designed to "work" with single securities (as opposed to mutual funds), such a reading of the requirement would clearly raise a number of operational challenges, not the least of which would be to monitor on an ongoing basis, when the security could have "significant participation."

In this regard, the DOL had indicated that "significant number" of participants could be as little as five participants with a plan of 500 or fewer participants, or 1 percent for plans that are larger. Because the Section 404(a)(5) Disclosure Rules require timely updates of certain information, it would appear that attempting to apply those rules to every security in a brokerage account would likely be difficult, if not unworkable. It is also worth noting that if such "non-designated investments" were held to be subject to the Section 404(a)(5) Disclosure Rules, then service providers—including brokerage houses—might also be viewed as being subject to the Section 408(b)(2) regulations in connection with the information provided under Section 404(a)(5) Disclosure or otherwise face the prospect that their fees from the products sold and transactions entered into could result in non-exempt prohibited transactions.

Not surprisingly, there was widespread concern among plan sponsors and other market participants alike that the plain reading of Q&A 30 could result in rendering brokerage windows unworkable in all but the most narrowly tailored platforms. Although it is unclear whether the DOL believed it was creating new law with Q&A 30, it is fair to observe that when the DOL issued Q&A 30, many commentators, including then-U.S. Senator John Kerry (now U.S. Secretary of State) expressed concerns about Q&A 30, with some suggesting that its release established, or ran dangerously close to establishing, new rules, without the benefit of the ordinary regulatory process with opportunity for comment.

[1] FAB 2012-02 may be found at http://www.dol.gov/ebsa/regs/fab2012-2R.html.

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In response to these concerns, the DOL amended the question later in 2012 (now renumbered as Question and Answer 39 ("Q&A 39")), but also explained that a plan fiduciary's ***failure to designate investment alternatives***, for example, by offering no menu of core investment options other than a brokerage window to avoid the regulation's investment-related disclosure requirements, may raise questions under ERISA's Section 404 general statutory duties of prudence and loyalty.[2] This statement itself caused further unease for some, suggesting that the DOL's revised language continued to upset established substantive expectations of plan fiduciaries, and introduced new requirements with respect to non-designated investment alternatives without the benefit of undergoing the required regulatory process.

Interestingly, neither Q&A 30 nor Q&A 39 appeared to address the possibility that there could be large costs to participants and plan sponsors alike under any actual or implied duty. For example, it is uncertain whether the DOL considered if employers (particularly smaller employers) would simply not offer a qualified plan at all if fiduciary responsibility were imposed on an employer over the exercise of participants' individually directed plan brokerage window investments. With a general policy designed to afford participants control over their retirement investments, such a result would appear to be doubly disadvantageous to plan participants as they would neither have any control over their retirement plans, nor have any retirement plans over which they would have control. Nor did there appear to be any empirical evidence offered that would justify a concern that sponsors adopt brokerage windows out of an attempt to avoid ERISA's fiduciary rules, aside from, perhaps, some anecdotal suggestions to the contrary.

Indeed, many plan fiduciaries who make the decision to establish a brokerage window feature in the context of a 401(k) plan would already be exercising their fiduciary responsibilities. For example, as Q&A 39 notes, in selecting the brokerage window providers the plans' fiduciaries would need to exercise fiduciary care "including taking into account the nature and the quality of services provided in connection with" the brokerage window. But for Q&A 30 and Q&A 39, it does not appear that there has been any formal or informal regulatory guidance under ERISA nor litigation finding the establishment of a brokerage window *per se* imprudent under ERISA. It would appear that such a result would run contrary to the emphasis ERISA and the DOL have placed on individuals' control over their own retirement accounts.[3]

In addition, it is noteworthy that many brokerage windows for qualified retirement plans (such as 401(k) plans) resemble other common retirement vehicles for smaller employers, like simplified employee plans ("SEPs") and SIMPLE IRAs. It would appear that the approach articulated by Q&A 30 would also apply to SEPs and SIMPLE IRAs, but for the fact that SEPs and SIMPLE IRAs are not subject to the Section 404(a)(5) Disclosure Rules or ERISA more generally. Such a result could have the paradoxical effect of driving participants out of Section 401(k) and into SEPs and SIMPLE IRAs.

Finally, it is interesting that the concern articulated in Q&A 30 by the DOL—that a failure to designate a "manageable" number of investment options results in a potential fiduciary breach—cited to a 2009 decision of the U.S. Court of Appeals for the Seventh Circuit for support. In that case, "*Hecker I*,"[4] the Seventh Circuit concluded that plan participants could not succeed in alleging that certain investment options offered under the plan had allegedly high fees when the plan offered participants not only 26 investment options but also, through a brokerage window, ***more than 2,500 funds*** unaffiliated with the brokerage. The court found that the plans offered "a sufficient mix of investments for their participants." The plaintiffs in *Hecker I* requested a rehearing, and the DOL supported the request ("Hecker II")[5] because it was concerned that *Hecker I* could be read as suggesting that plan fiduciaries could avoid liability by simply offering a large number of options. The Seventh Circuit denied the rehearing. Significantly, its decision explicitly acknowledged the DOL's concern:

> [The DOL Secretary also] fears that our opinion could be read as a sweeping statement that any plan fiduciary can insulate itself from liability by the simple expedient of including a very large number of investment alternatives.

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[2] Q&A 39 reads:

Q39: A plan offers an investment platform that includes a brokerage window, self-directed brokerage account, or similar plan arrangement. The fiduciary did not designate any of the funds on the platform or available through the brokerage window, self-directed brokerage account, or similar plan arrangement as "designated investment alternatives" under the plan. Is the platform or the brokerage window, self-directed brokerage account, or similar plan arrangement a designated investment alternative for purposes of the regulation?

A39. No. Whether an investment alternative is a "designated investment alternative" (DIA) for purposes of the regulation depends on whether it is specifically identified as available under the plan. The regulation does not require that a plan have a particular number of DIAs, and nothing in this Bulletin prohibits the use of a platform or a brokerage window, self-directed brokerage account, or similar plan arrangement in an individual account plan. The Bulletin also does not change the 404(c) regulation or the requirements for relief from fiduciary liability under section 404(c) of ERISA or address the application of ERISA's general fiduciary requirements to SEPs or SIMPLE IRA plans. Nonetheless, in the case of a 401(k) or other individual account plan covered under the regulation, a plan fiduciary's failure to designate investment alternatives, for example, to avoid investment disclosures under the regulation, raises questions under ERISA section 404(a)'s general statutory fiduciary duties of prudence and loyalty. Also, fiduciaries of such plans with platforms or brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan are still bound by ERISA section 404(a)'s statutory duties of prudence and loyalty to participants and beneficiaries who use the platform or the brokerage window, self-directed brokerage account, or similar plan arrangement, including taking into account the nature and quality of services provided in connection with the platform or the brokerage window, self-directed brokerage account, or similar plan arrangement.

[3] That said, plan fiduciaries contemplating adding a brokerage window would be wise to adopt a prudent process for making any such decisions. Plan sponsors may also wish to consider alerting plan participants that investment options are not monitored by the plan's fiduciaries, and that they be encouraged to engage an investment adviser to the extent they deem appropriate.

[4] *Hecker v. Deere & Co.*, 556 F.3d 575, 45 EBC 2761 (7th Cir. 2009) (28 PBD, 2/13/09; 36 BPR 357, 2/17/09).

[5] *Hecker v. Deere & Co.*, 569 F.3d 708, 47 EBC 1097 (7th Cir.2009) (121 PBD, 6/26/09; 36 BPR 1567, 6/30/09).

Ultimately, the Seventh Circuit rejected the DOL's concern because *Hecker I* was "tethered closely to the facts before the court," including the fact that the plaintiff did not allege that the inclusion of any of the investment options, such as a brokerage window, was "unsound or reckless."

RFI and DOL Next Steps— Will Anyone Be Left Out in the Cold?

Following up on these events in 2012, the DOL released a request for information ("RFI") on Aug. 20, 2014.[6] In trumpeting the release, Phyllis C. Borzi, assistant secretary for the Department of Labor's Employee Benefits Security Administration, noted: "We promised employers and other plan sponsors and fiduciaries that we would look into the use of brokerage window features."[7] She also said: "Our goal in issuing this RFI is to determine whether, and to what extent, regulatory standards or other guidance concerning the use of brokerage windows may be necessary to adequately protect participants' retirement savings."[8]

What will the DOL do with the results of the RFI? It is too early to say. The DOL could merely be looking for a better understanding of how brokerage windows work; it may also be looking to understand how the Section 404(a)(5) Disclosure Rules, as finalized, do or do not work with brokerage windows. Of course, the DOL could also be engaging in a deeper and comprehensive review of the practices involving brokerage windows with a view towards broader regulation.

Helpfully, the RFI indicates that "[t]he Department is committed to engage in discussions with interested parties to help determine how best to assure compliance with these [fiduciary] duties in a practical and cost-effective manner." But, in support of a potentially more maximalist undertaking, the RFI also notes that:

> This includes considering *whether amendment of relevant regulatory provisions or interpretive guidance may be appropriate* and necessary to ensure that participants and beneficiaries with access to brokerage windows are adequately protected. [Emphasis supplied].

The DOL also notes that:

> The RFI will focus on why, under what circumstances, and how often these brokerage windows are offered and used in ERISA plans, *and the legal and policy issues that relate to such usage*. The Department wants to make sure that participants *are not exposed to undue risks from brokerage windows and that plan fiduciaries properly understandthe scope of their ongoing responsibilities with respect to brokerage windows*." [Emphasis supplied].

Observations

Section 404(c) of ERISA provides a framework by which a plan's fiduciary may limit its fiduciary liability with respect to investment decisions effected by plan participants under 401(k) plans, subject to meeting the terms and conditions of those rules. Under that provision, although a plan fiduciary is responsible for the prudent selection and monitoring of investment options offered under the plan, the fiduciary is not liable under ERISA solely by reason of investment losses occurring with respect to participants' accounts if the participants have been afforded the requisite control, are supplied with the required information, and the plan otherwise complied with the contours of the rule. One of the major themes behind Section 404(c) therefore, is participant control over designated investment alternatives.

It is interesting to note that in 1992, when the DOL adopted its regulation under ERISA Section 404(c), there was no reference to brokerage windows, and it does not appear that since the release of those regulations, the DOL has ever indicated that there is a fiduciary duty under ERISA to prudently select or monitor investments selected by participants in a brokerage window. Instead, the Section 404(c) regulation makes clear that plan fiduciaries have certain duties regarding the prudent selection and monitoring of DIAs, but the regulation, in turn, defines the term to mean "a specific investment ***identified by a plan fiduciary*** as an available investment under the plan." [emphasis supplied].[9] A DIA would thus not include investments selected and made by individual participants through a brokerage window. The regulation's approach is consistent with established policy and common sense: it is hard to see why a plan fiduciary would be deemed to have fiduciary duty over such non-designated investment alternatives where sufficient control was maintained by the participant. In support of this reading, it is interesting to note that the original Section 404(c) regulations already expressly provide the following illustration:

> A participant, P, independently exercises control over assets in his individual account plan by directing a plan fiduciary, F, to invest 100 percent of his account balance in a single stock. P is not a fiduciary with respect to the plan by reason of his exercise of control and F will not be liable for any losses that necessarily result from P's investment instruction.

This language does not suggest that F's protection from fiduciary responsibility is somehow conditioned on F's monitoring of P's investment decisions. Quite the contrary. It in fact seems to endorse the proposition that F is not a fiduciary by reason of P's maintenance and exercise of investment control. Accordingly, such language is consistent with the Seventh Circuit's holdings in *Hecker I* and *Hecker II*, but would appear to be inconsistent with the proposition for which the DOL alleged those cases to stand for in connection with Q&A 30, let alone a new interpretation of such language that has been on the books for years through a new question to a new regulation.

The Section 404(a)(5) Disclosure Rule similarly applies to DIAs. Unsurprisingly, given that the Section 404(a)(5) Disclosure Rule is modeled off of, and is promulgated under, Section 404(c) of ERISA, the language is remarkably similar, connoting consistency across both time and rules over 20 years:

> any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual account. The term 'designated investment alternative' *shall not include* 'brokerage windows,' 'self-directed brokerage accounts,' or similar plan arrangements that enable partici-

[6] Available at http://op.bna.com/pen.nsf/r?Open=abyf-9qbl3u.

[7] Available at http://www.dol.gov/opa/media/press/ebsa/EBSA20141523.htm.

[8] *Id.*

[9] 29 C.F.R. § 2550.404c-1(e)(4).

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pants and beneficiaries to select investments *beyond those designated by the plan.*[10] [emphasis supplied].

One would have thought that many plan sponsors and market participants beginning in 1992, through and including 2012 when the Section 404(a)(5) Disclosure Rules were finalized, would be justified in presuming that investments offered under brokerage windows of 401(k) plans are simply not investments "designated" by a plan. Ignoring a plain English read of the term—that "designated investment" requires a "designation" by someone other than the plan participant—it is perhaps worthy of mention that, as the above selection indicates, the Section 404(a)(5) Disclosure Rule itself uses the term "designated investment alternative" when noting that the disclosure rules are not designed to relieve a fiduciary of its duties of prudence with respect to "designated investment alternative offered under the plan." There is no accompanying language referring to a plan fiduciary's duties to "undesignated" investment alternatives.

Request for Information

We suspect many plan sponsors and market participants will likely be interested in following this development, and providing information to the DOL to the 39 or so questions posed in the RFI.[11] Although it is far too soon to see where the DOL will go with the answers it receives, it would appear that any effort by the DOL, maximalist in scope or otherwise, would require solid and thoughtful information from plan sponsors and market participants. At a minimum, we would hope that in connection with any further efforts, the DOL would properly address each of the following:

- Articulating the perceived problem that may warrant further regulatory action, and what the costs and benefits are in taking any such action.
- The extent to which employers may reconsider establishing or maintaining a plan in the absence of being able to offer a brokerage window.
- The extent to which participants will be adversely impacted by the elimination of brokerage windows due to employer concerns about fiduciary liability, including as to investment returns and employee/participant choice.
- The potential implications to participant account balances if participants are forced to liquidate their investments held in a brokerage window, including costs of sale, and whether or not such sale occurs at a time that is fortuitous in the market.
- The potential implications to sponsors and fiduciary exposure in (a) choosing to maintain brokerage accounts subject to heightened fiduciary and reporting duties, or (b) eliminating brokerage accounts and facing possible claims by participants who may have been "forced" to sell their positions at inopportune times.
- The extent to which record keeping systems can gather and disclose the required information for brokerage window investments, assuming that the DOL requires the Section 404(a)(5) Disclaimer Rules to be applicable to brokerage window arrangements. The initial costs and ongoing burdens associated with building out any such systems for compliance, and the impact to plans' costs.
- The implications to employers arising out of adverse employee reaction occasioned by the elimination of brokerage windows.
- An understanding of the purposes for which brokerage windows are established, and the typology of sponsors making use of these features.
- How brokerage windows are used by smaller employers.
- Any intended or unintended effect on any such actions with respect to SEPs or SIMPLE IRAs, given that those plans are common among small businesses and generally offer participants the flexibility to invest in products that are utilized through brokerage windows.
- The complexities and difficulties involved in plan sponsors' monitoring on an ongoing basis whether any given security or other product available under a brokerage window has significant participation.

Responses to these and other questions may be submitted via email to e-ORI@dol.gov (include "RIN 1210-AB59 Brokerage Windows RFI" in the subject line of the message) through Nov. 19, 2014. Plan sponsors, financial market participants and others will likely want to follow the status of this project and the potential impacts for their plans and/or businesses.

[10] 29 C.F.R. § 2550.404a-5(h)(4).

[11] The RFI is available at http://op.bna.com/pen.nsf/r?Open=abyf-9qbl3u.